Volume 87

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

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There is probably no other professional or academic pursuit in which aphorisms and maxims are so prevalent and so enduring as they are in the world of market analysis and investing.

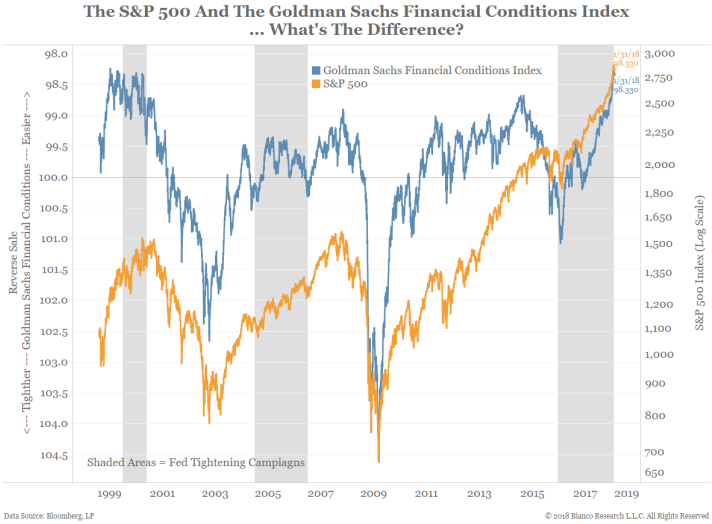
Indeed, there is a very good reason for that being the case, which is that so many of these pieces of market lore are just as relevant and insightful today as they were on the day that they were first spoken.

There are several of these "pearls of wisdom" that we believe are particularly relevant in the current market environment, when the powerful secular uptrends in both stocks and bonds are very long in the tooth.

One such particularly timely maxim comes from Daniel Mitchell, who noted back when he was a Senior Fellow at the CATO Institute that "Capital markets without losses are like religion without hell." In other words, without there being painful consequences associated with doing evil, in the case of religion, or making uninformed or ill-conceived decisions, in the case of investing, there is nothing to help dissuade someone from continuously making other "bad" decisions.

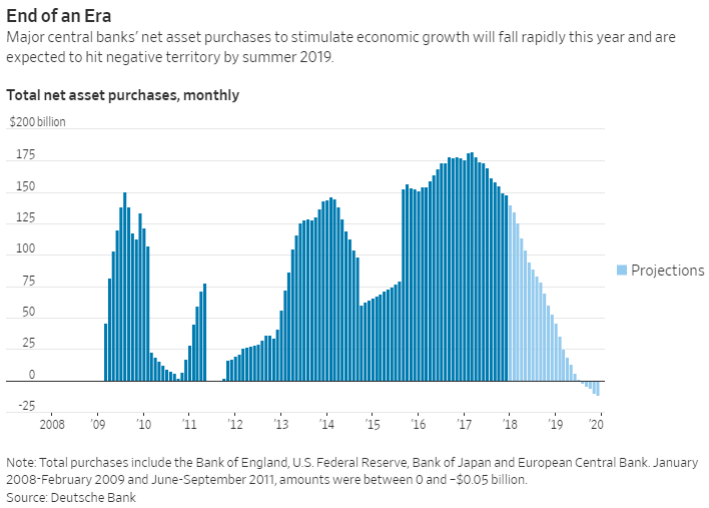
Such has been the case in the capital markets, where stocks, bonds and securitized real estate have benefitted from nine years of central banks pumping trillions of dollars of monetary stimulus into the global economy, with a primary objective of inflating the prices of financial assets.

Their goal was to create a "wealth effect" by increasing the value of people's homes and retirement accounts, under the premise that it would improve consumer confidence, boost consumer spending, and help to stimulate the global economy out of the "Great Recession". With the benefit of hindsight, their plan clearly worked.

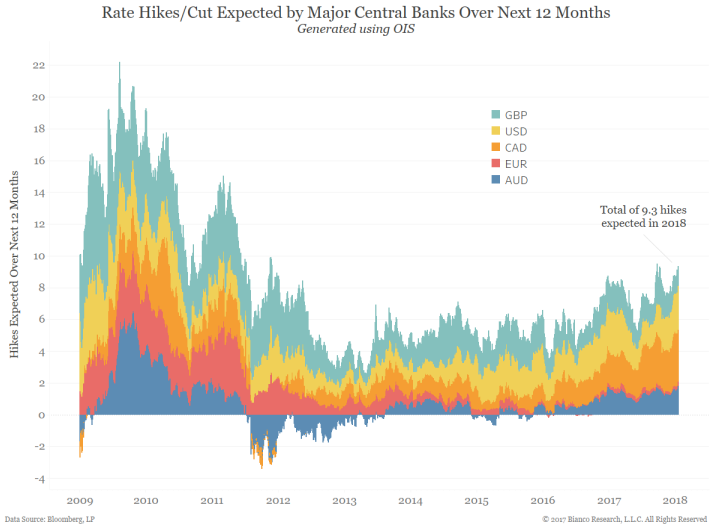


You can see the impact of all this global monetary stimulus (near-zero-percent interest rates and explosive growth in the supply of money) in the Goldman Sachs Financial Conditions Index (blue line). This measure considers interest rates, money supply, asset prices, currencies, credit availability and a variety of other factors that help to influence how accommodative conditions are for economic growth and appreciation in the prices of risk assets. You will note the almost perfect correlation (albeit a different amplitude) between this index and the trend in the S&P 500 stock index.

However, there is currently one very noteworthy anomaly in this measure which is that, while periods of monetary tightening on the part of the Federal Reserve (higher interest rates and reduced money supply), which are illustrated by the shaded grey areas, normally cause this measure of current conditions to flatten and then ultimately decline, it currently continues to grow even stronger despite the Fed both raising interest rates and shrinking its balance sheet (quantitative tightening).

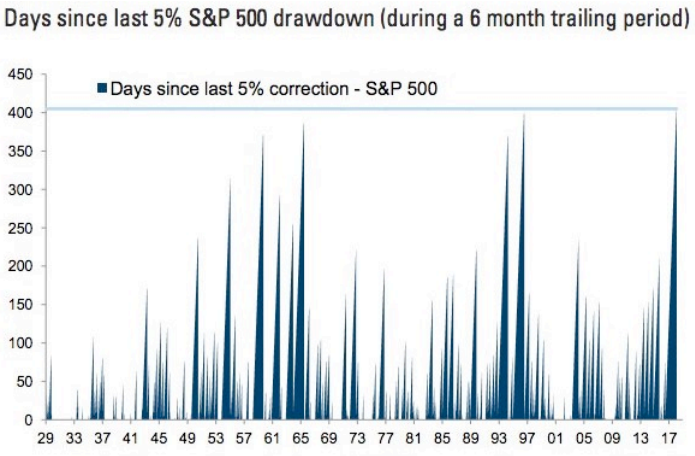


In our opinion, this is attributable to the fact that monetary stimulus since the financial crisis has been so global in nature, and that monetary easing outside of our borders is still more than sufficient to offset the tightening on the part of the Fed.



However, we believe that it is virtually inevitable that, on a global basis, quantitative easing will soon be replaced by quantitative tightening, and what has been a powerful tailwind for the markets will transition into an equally powerful headwind.

This is of great importance, when you consider that it has largely been the result of too much central-bank-injected money chasing too few securities that has made most of the equity, debt and securitized real estate markets so impervious to losses.



To put the recent Teflon-nature of the capital markets into some perspective, we are currently in the midst of the longest period in the history of the S&P 500 (404 days) without a decline of at least 5%; it has been more than two years since the market concluded its most recent 10% decline, and almost nine years since the conclusion of the last bear market (a 20% or greater decline).

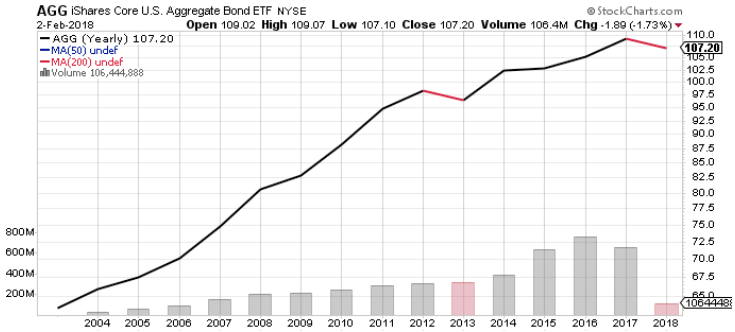
In contrast, since 1900, blue-chip domestic stocks have historically averaged three 5% declines per year, one 10% decline per year, and a bear market every three and one-half years.

A History of Declines

Type of Decline	Average Frequency[1]	Average Length[2]	Last Occurrence
-5% or more	About 3 times a year	47 days	August 2015
-10% or more	About once a year	115 days	August 2015
-15% or more	About once every 2 years	215 days	October 2011
-20% or more	About once every 3½ years	341 days	March 2009

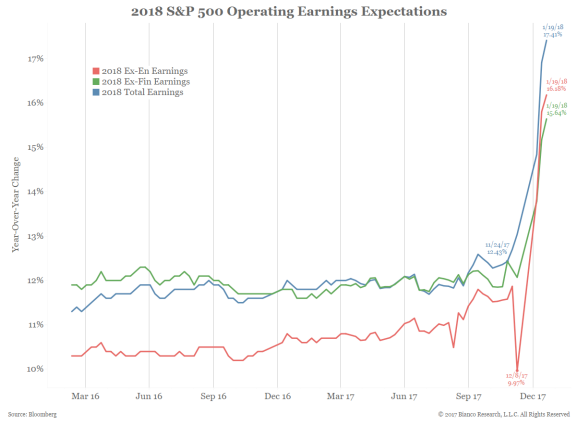
While recent stock market history clearly illustrates "a religion without hell", the Teflon-nature of equities pales in comparison to that of the debt markets where, aside from a very modest 2% loss in 2013, bond prices have enjoyed a virtually uninterrupted run higher. That is, until this year.

Indeed, this comment understates the buoyancy of debt securities, which have actually been in a secular bull market since 10-year Treasury yields peaked out in October of 1981 at 16.1%, before reaching lows of 1.4% in July of last year (bond prices move inversely to yields).



Without losses, there is no fear, and without fear, both bullishness and market valuations reach unsustainable levels, which described the equity markets in particular, at the end of January.

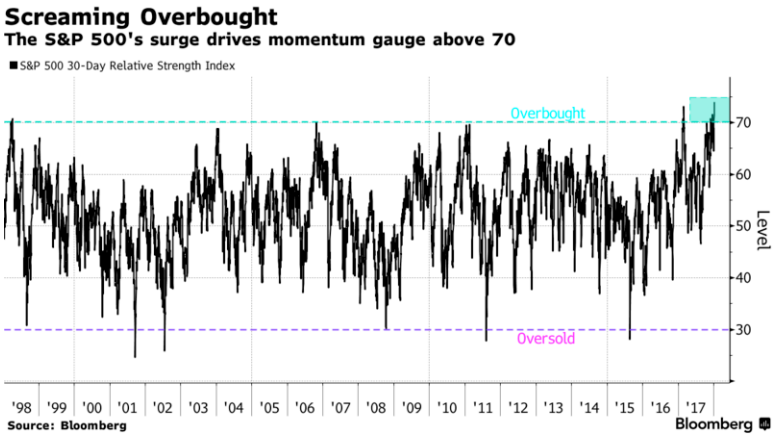
Of note, there are two reasons why we are placing more importance on today's excessive bullishness than we are on inflated valuation levels. First, we suspect that valuation issues may prove only transitory, as accelerating revenues and the benefits of corporate tax reform have the potential to make current prices seem only modest when compared to corporate profits. You can see this illustrated in the latest revisions to analysts' earnings expectations.



Second, one can make a very strong argument that bull markets usually don't end when the fundamentals turn negative, or because they get old or expensive. They end when they run out of bears that can still be converted to bulls, thus injecting new money into the markets, or when all potential good news is already fully discounted into market prices.

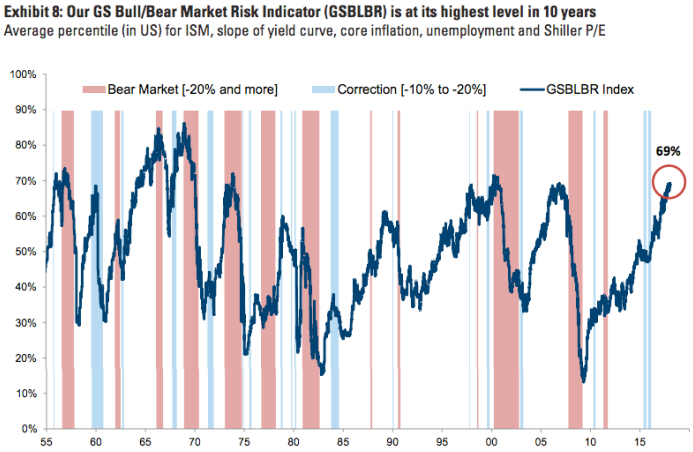
This is why we believe that it is so important to be on the lookout for signs of either "bearish capitulation", where long-term bears finally give up on the market ever giving them another buying opportunity, and they hold their nose and jump into the market (normally just before it rolls over), or signs of a "fear of missing out" market, where people who oftentimes are not even normally investors will jump into the markets because they hear about how everyone else is getting rich, and they just want their share of the "easy money".

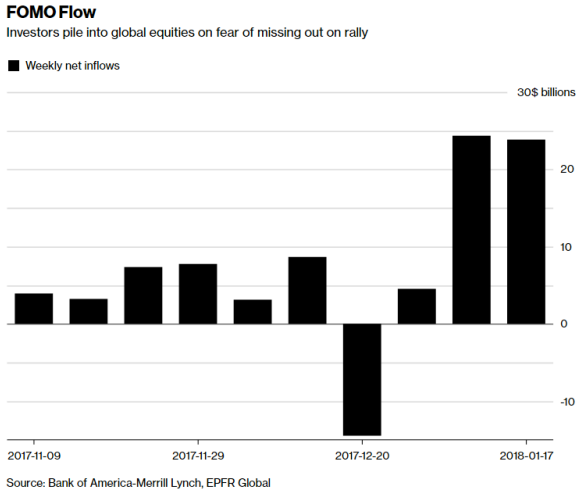
These are both classic indications that the market is running out of bears to convert, and that at least some level of correction is almost inevitable, if for no other reason than to restore some balance and fear to the investor psyche, and to replenish the supply of bears that can be converted later. The all-important question is whether the presumed correction is just going to be a garden-variety 5% "wake-up call" or the start of something more substantial.



As of the end of January, the equity markets were indicating levels of over-confidence and complacency that virtually necessitate some catalyst to temper investor sentiment and quell dangerous levels of market exuberance.

The Conference Board survey of investor sentiment rose at the end of January to its highest (most bullish) level of all time. The late January Investors Intelligence Survey of investment newsletter writers revealed five bulls for every one bear, which is the most bullish reading since 1986, and the four American Association of Individual Investors surveys taken in January showed some of the most bullish numbers in history. Finally, the Goldman Sachs Bull/Bear Market Risk Indicator just soared to a euphoric level of 69%, which is a level that has historically preceded equity bear markets (shown in pink).

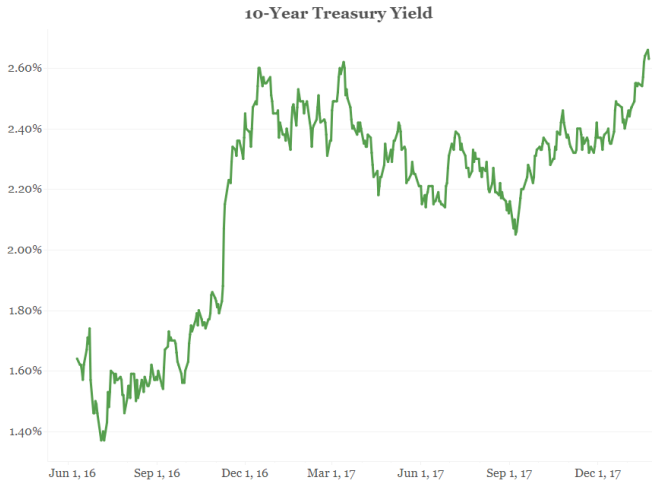




However, evidence of a "bear capitulation" was not limited to sentiment surveys. It was also evidenced by the fact that January witnessed some of the largest flows into equity mutual funds and exchange traded funds (ETFs) in the history of the US markets (including the single largest weekly inflow ever).

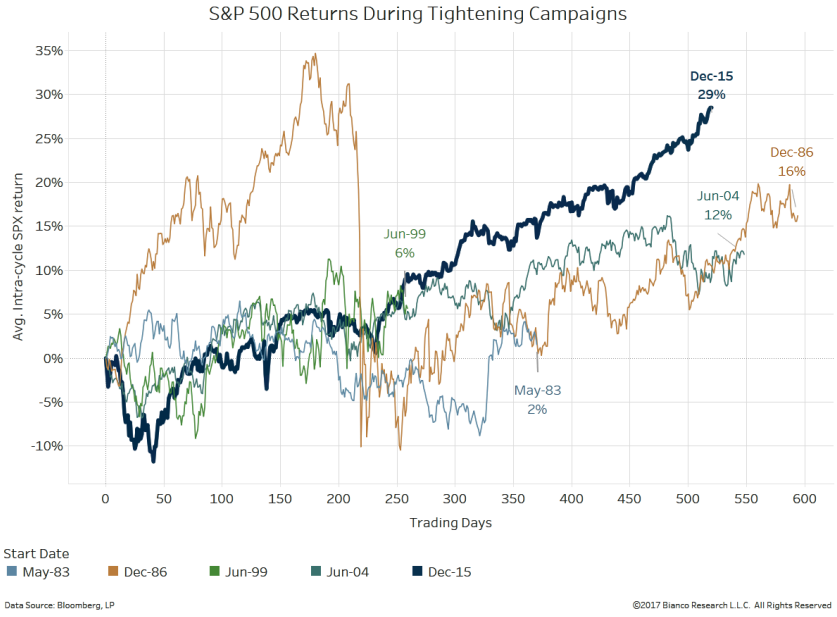
Perhaps most telling was a late January survey by BlackRock which showed that millennials, who have generally been very disinterested in investing in equities, were finally pouring into the equity markets. This 2018 survey showed that 42% of millennials are now investing, whereas a similar BankRate survey from 2017 showed that only 13% of millennials were invested in equities.

By the end of January, it was hard to find bears that had not already capitulated and put their buying power into the markets. New bears need to be found or created if the bull market is to sustain itself, and that will likely require some unanticipated bad news or a decline in market prices. Which brings us back to that all- important question of whether the equity markets are due for the aforementioned "5% wake-up call", or if there is something more foreboding on the horizon.



We suspect that the answer to that question lies in the bond markets in general; in the rate of ascent of interest rates in particular, and in whether it is the Federal Reserve or the markets themselves that ultimately determine the pace and timing of future interest rate moves.

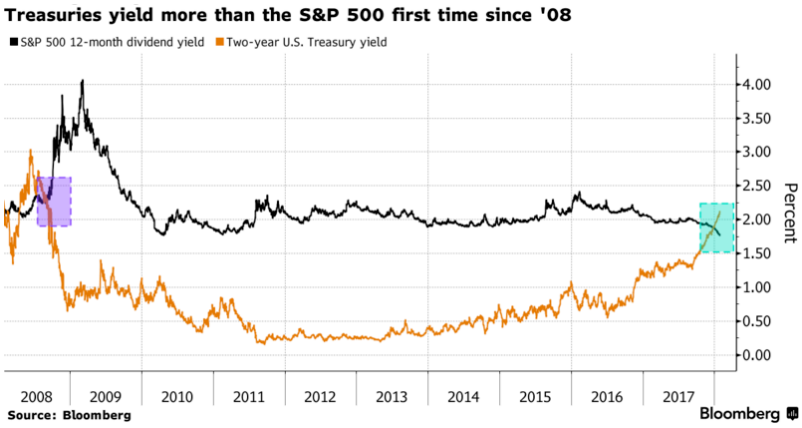
To explain, history teaches us that bull market advances can sustain themselves in the face of Fed tightening for so long as the rate increases are modest, predictable and systematic. Where equities tend to really suffer is when interest rate increases are rapid and/or unpredictable, or in situations where investors grow concerned that the Fed is "behind the curve" relative to inflation, and that they are not moving rates higher fast enough. In the later situation, certain institutional traders often known as "bond vigilantes" attempt to push rates higher by selling bonds, as a means of forcing the Fed to be more aggressive.



In such situations, a phenomenon called the "terminal interest rate dilemma" comes into play, where traders start pricing debt securities not based upon where short-term rates are at present, but instead at the "terminal rate" where they think that rates will ultimately end up at the end of the tightening cycle. This can cause the central bank to lose control of the interest rate policy, and cause rates to move higher much more quickly than The Fed would like.

That is a scenario that has historically troubled equity investors, as higher rates make bonds increasingly competitive versus stocks and reduce the current value of future earnings.

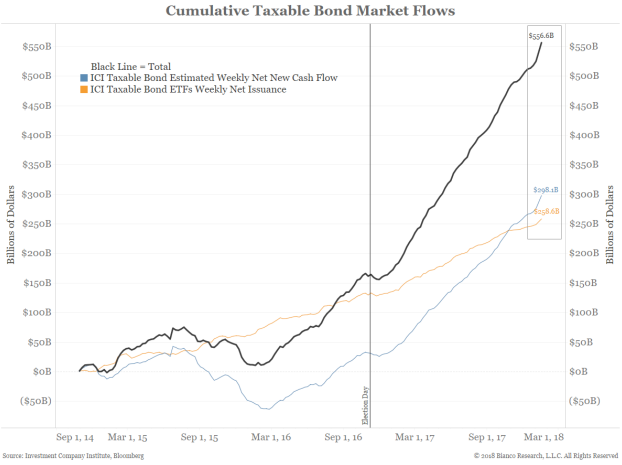
Newly-appointed Federal Reserve Chairman, Jay Powell, is acutely aware of the potential consequences of the upcoming normalization of monetary policy. Indeed, in the just-released transcript of the October 2012 Federal Open Market Committee meeting, Chairman Powell stated, "Meanwhile we look like we are blowing a fixed-income duration bubble right across the spectrum that will result in big losses when rates come up down the road. You can almost say that is our strategy."



Particularly in that light, it is noteworthy that the main difference that the analyst community sees between previous Fed Chairwoman Janet Yellen and her successor Jay Powell is that Powell is viewed as far less likely to intervene on behalf of the markets if they start to experience significant losses.

Clearly, the prospects for the bond markets do not look good. The yield on the 10-year Treasury is already at a four-year high, and the issuance of new Treasury securities in 2018 will double 2017 levels because of the Fed's decision to start shrinking its balance sheet. On top of everything else, we are finally starting to see some long-awaited signs of inflation, which is always the bane of the bond markets.

While the longer-term outlook for bonds seems particularly daunting, there may be some relief in the short term. Bond prices have already priced in a lot of bad news and, with yields on bonds now generally higher than yields on stocks, bond prices may get some near-term support from yield-hungry investors.



In regard to equities, and the question regarding the scope of the presumed correction to come, we will be keeping a close eye on the bond markets, and how rapidly yields push higher. We still maintain the opinion expressed in the summary to last month's report regarding how "very overdue equity prices are for a corrective decline" and can even envision a possible decline of 10% or more, if interest rates accelerate to the upside.

At the same time, we are still expecting to see the so-called "Great Rotation" take place before the end of the current economic cycle and believe that this potentially massive shift of money out of bonds and into stocks will likely catalyze one more significant leg higher in stocks, as disgruntled bond investors increasingly grow tired of losses in their bond funds and move over to equities. After all, that would be the ultimate bear capitulation. In the meantime, such an event currently seems far from imminent when you consider that money is still pouring into bond funds despite their deteriorating fundamentals.